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SUBJECT: South China Bankers See Signs of Economic Improvement, Skeptical on RMB Internationalization

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¶1. (SBU) Summary: Guangzhou bankers differ over whether South China's economy is as bad off as some media reports would have us believe. They agreed, however, that Beijing is increasing the pressure to expand lending to small and medium enterprises. They expressed interest in the Chinese government's new renminbi (RMB) settlement proposal, but identified obstacles that continue to impede the use of the RMB as an international currency. One noted advantages that Hong Kong banks will enjoy with the next round of opening under the Closer Economic Partnership Arrangements (CEPA). A business leader from the Hong Kong Chamber of Commerce China-Guangdong (HKCCC) told of strong support for Hong Kong-Guangdong economic integration on both sides of the border. End summary.

Positive Economic Signs in Guangdong

¶2. (SBU) The economic situation in Guangdong isn't nearly as dire as reports in the South China Morning Post would have you believe, according to a senior executive at Guangdong Development Bank (GDB). In a meeting with ConGen Hong Kong and ConGen Guangzhou econoffs participating in a joint reporting effort to look at southern China financial issues, the GDB executive explained that his bank had more problems with non-performing loans (NPLs) at its Hangzhou branch in Zhejiang than in its Guangdong branches. The executive argued that enterprises in Guangdong had learned valuable lessons from the Asian financial crisis in the late 1990s. Many businesses in the Yangzi River Delta (YRD), on the other hand, had only known success and were unprepared for the economic downturn, according to the banker.

¶3. (SBU) However, he also noted differences in the banks loan portfolios in the two locations that helped explained the variation in performance. GDB has relatively few clients in those industries hardest hit by the downturn, including export manufacturers. In addition, the Guangdong provincial government purchased many of the bank's NPLs before Citibank bought its stake in GDB.

¶4. (SBU) An executive from the Bank of East Asia's Guangzhou branch

was also fairly optimistic on the PRD's economic prospects. He said that although many Hong Kong-owned enterprises in the PRD had closed last year, the wave of closures was mostly finished; those that needed to close had already shut down. Those left will survive the downturn, he said, and gain market share at the expense of firms that have already been eliminated.

¶5. (SBU) A senior executive from Standard Chartered Bank had a less positive outlook. He said the impact of the economic slowdown had been more severe in southern China due to the high concentration of small and medium enterprises (SMEs) here. The executive predicted exporters in the PRD would find it difficult to shift their focus to the domestic Chinese market or to emerging overseas markets. He cited the example of a logistics company in Shenzhen that provided services for exporters to Africa and the Middle East; the firm recently closed because it couldn't find enough business. The banker predicted that by the time the economic downturn has run its course about 30 percent of businesses in Guangdong will have failed.

Beijing Pushing SME Credit

¶6. (SBU) The BEA and Standard Chartered bankers both commented that Beijing was strongly encouraging banks to lend to SMEs. The Standard Chartered executive said that domestic banks had previously dealt mostly with state-owned enterprises (SOEs) but are now being forced to extend loans to SMEs. Banking regulators have even required local banks to set up internal sections specifically devoted to SME business. Standard Chartered has been providing services to SMEs in Guangdong since 2003 and has a staff of 20

dedicated to SME clients, but it is still not a large part of their business. The BEA banker said that his firm serves SME clients because it has an open door policy that doesn't permit turning qualified clients away. However, SME clients are cost intensive. The loan amounts are small and supervision is more intensive than for larger firms. The bank always asks SME loan applicants for collateral and SME clients only comprise about 10 percent of BEA customers in Guangdong.

RMB Internationalization - Obstacles Remain

¶7. (SBU) Banking customers are interested in the option of RMB trade settlement under the Chinese government's new proposal, but expectations are low, according to the BEA executive. Noting that the regulations for the settlement plan had not yet been released, he said his bank was waiting and watching closely, but progress had been slow. A business leader from the HKCCC agreed that expectations were low, saying that Hong Kong-based companies still prefer settlement in Hong Kong or U.S. dollars even though some Guangdong manufacturers would rather settle in RMB.

¶8. (SBU) Commenting on BEA's RMB bond sale in Hong Kong, the BEA executive denied reports that receipts from the sale would be used to set-up a new sub-branch in Guangdong. Instead the bond receipts will be used to finance RMB lending in China, he said. The bank is not able to transfer RMB deposits from Hong Kong directly to its Guangdong branches, but is permitted by Chinese currency exchange regulators to transfer the bond receipts.

¶9. (SBU) The bankers pointed out that lack of convertibility and other regulatory obstacles to currency exchange continue to hamper business transactions between the mainland and other jurisdictions, including Hong Kong and Macau. The Standard Chartered banker said large amounts of cash continue to be smuggled across the Hong Kong-Shenzhen border, noting that 90 percent of China's cash settlements take place in Shenzhen. The GDB executive explained that his bank had encountered difficulty getting State Administration of Foreign Exchanges (SAFE) approval for an inbound transfer after a foreign buyer bought a non-performing loan associated with a commercial building project in the Shanghai area. In addition, the bank was unable to get SAFE approval to allow a client with savings in GDB's Beijing branch to use the money to

secure a loan from the bank's Macau branch. Standard Chartered execs agreed that SAFE's sluggishness in approving foreign currency transactions is a significant problem.

Challenges for Foreign Banks

¶10. (SBU) Foreign banks in China still face unique challenges, according to the Standard Chartered executive. Chinese banks strong network of local connections and vast scale give them a major advantage. In addition, the Chinese banks, under pressure to expand liquidity, are now offering lending rates that are half of what Standard Chartered is able to offer, he said. The Chinese banks have also learned a lot from foreign banks that have invested in China, especially in the area of risk assessment. However, the banker said that foreign banks continue to have an advantage in their international service networks and their ability to offer sophisticated supply chain financing. Standard Chartered has been able to leverage these advantages particularly well with a growing number of clients looking to expand in Africa where the bank has been operating for more than a century.

¶11. (SBU) Both the Standard Chartered and BEA bankers believe the sixth round of CEPA will provide real benefits for Hong Kong banks in the mainland. The new measures will allow Hong Kong banks to open sub-branches in Guangdong Province much more easily. Capital requirements for each individual sub-branch are far lower than those required for branches.

Hong Kong-Guangdong Integration

¶12. (SBU) There is a high level of interest in both Guangdong and

Hong Kong in pursuing further integration of the two economies, according to the HKCCC business leader. He told us that each side's appetite for integration has varied as their financial circumstances have waxed and waned. Hong Kong and Guangdong now see the YRD as a major competitor, boosting the appeal of integration to both sides. The HKCCC executive claimed that Guangdong Party Secretary Wang Yang was pushing integration and the political leadership in Beijing was supportive too. He said that Hong Kong and Guangdong were both preparing individual proposals for enhancing integration that needed to be submitted to Beijing in September, noting that he had been asked to provide input on each side's proposals.

¶13. (SBU) The HKCCC executive highlighted the service sector as one area with high potential for further cross-border integration. He pointed out that service sector companies now made up more than 50 percent of HKCCC's Guangdong membership, which had formerly consisted primarily of export manufacturers based in Dongguan. Explaining that Guangdong enterprises are heavily concentrated in manufacturing with little interest in expanding production to Hong Kong's high-wage labor market, he suggested that the two governments need to do more to encourage Hong Kong service providers to expand to Guangdong. Tax incentives aren't enough, he said. Local governments in Guangdong should provide business matching services to help Hong Kong firms identify clients. The Hong Kong service companies will be unwilling to set up an office in Guangdong until they have already established a client base, according to the executive.

¶14. (SBU) This cable was a joint reporting effort by ConGen Guangzhou and ConGen Hong Kong.

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